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Pew Informational Testimony for H.B. 4602
Related to the Countercyclical Budget and Economic Stabilization Fund

House Appropriations Committee
September 26, 2018

Dear Chair Cox and members of the Committee:

Thank you for your consideration of House Bill 4602 (H.B. 4602). This legislation makes reforms to the Countercyclical Budget and Economic Stabilization Fund (BSF), including modifying the provisions for withdrawal from the fund, and increasing the maximum amount of cash that the fund may hold. Myself and my colleagues at The Pew Charitable Trusts have conducted extensive research on all aspects of budget stabilization fund practices, and would like to use this opportunity to provide 50-state context for these policy choices as you consider the bill.

Bill Places New Limits on the Amount that may be Withdrawn from the BSF

H.B. 4602 would place new limits on the amount that may be withdrawn from the BSF in certain circumstances. Under current law, Michigan may withdraw from the BSF if adjusted personal income is projected to decline. The withdrawal is limited to an amount equal to the percentage decline of personal income multiplied by total state general fund-general purpose revenue.

Under the proposed law, the withdrawal amount would instead be limited to 25 percent of the BSF balance, with a provision that would allow more to be withdrawn if there are two consecutive years of decline in adjusted personal income.

50-State Context for Withdrawal Rules

- **Budget Stabilization Funds:** 48 states have formal budget stabilization funds in law. Of those states, 36 have funds codified in statute, nine are included in the constitution, while three have funds established in both the state's constitution and statute. Michigan's BSF exists in statute only.
- **Withdrawal Conditions:** 42 states have withdrawal conditions that must be met before money can be transferred from the fund. Michigan's current withdrawal condition is linked to a decline in adjusted state personal income. Pew's research recommends states connect withdrawal conditions to some measure of fiscal or economic volatility, to ensure funds can be accessed during an economic downturn. For context, Michigan is one of three states that uses adjusted personal income to determine when transfers may occur. Examples of other withdrawal conditions include when general fund revenue is projected to decline, or when actual revenue collections miss the forecast that the enacted budget was based on.
- **Withdrawal Limits:** Nine states withdrew the entirety of their budget stabilization funds' balance in the first year of the Great Recession, leaving them with no savings to pull from during the following years. To avoid this kind of fund depletion, many states limit rainy day fund withdrawals—reserving some of the balance for future use. For example, Virginia limits withdrawals to half of the fund balance or half of the budget shortfall, whichever is

less. When deciding if a limit is appropriate, Michigan should consider the purpose of their budget stabilization fund and history of revenue declines during a recession. For example, during the first year of the Great Recession, state general fund-general purpose revenue declined by $2.0 billion – or 21.3 percent – in Michigan. For context, the BSF had an estimated closing balance of $886.1 million in fiscal year 2018.

Bill Would Raise the Maximum Allowable Balance of the BSF

H.B. 4602 would also raise the maximum balance for the BSF from 10 to 15 percent of combined general fund-general purpose and school aid revenues.

50-State Context for Maximum Balances

- **Budget Stabilization Fund Caps:** Of the 48 states with budget stabilization funds, 44 have a maximum balance or savings target. These targets can help policymakers reach consensus around how much a state needs to save. They bring increased transparency about the reasons for holding money in reserve, and they prevent states from under—or over-saving—during times of economic growth.
- **History of Fund Caps:** When budget stabilization funds were initially created in states, most set their caps at 5 percent of spending or revenue. However, in an era of increased revenue uncertainty, many have since increased their limits so they are better prepared for a downturn. Most states now have caps set between 6 and 10 percent of spending or revenue.
- **Setting an Appropriate Fund Cap Based on Evidence:** As states work to balance saving for future needs against funding other important priorities, an increasing number are using evidence-based approaches to determine how much they want to have on hand to navigate the next recession. For example, a September 2018 analysis by S&P Global Ratings found that Michigan would need reserves equal to 15 percent to fully cover just the first year of revenue declines from a severe recession. An analysis by Moody's Analytics, released the same month, estimated that state tax revenues would decline by 16.2 percent under their severe recession scenario for Michigan.

To help states better understand the adequacy of their reserve levels and what withdrawal limits are appropriate, The Pew Charitable Trusts recommends that policymakers periodically study their states' economic and revenue volatility. Such analyses can help states develop policies for rainy day funds that smooth budgets throughout the business cycle and align with each state's objectives and characteristics.

If you have any additional questions about Pew's research on state budget stabilization funds, please do not hesitate to contact me at SBailey@pewtrusts.org.

Sincerely,

Stephen Bailey

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